



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202

Report
No. 91-016

December 3, 1990

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (PRODUCTION AND LOGISTICS)
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT)
ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL MANAGEMENT AND COMPTROLLER)
DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Final Report on the Audit of Subcontract Prices on Firm-Fixed-Price Contracts Awarded to McDonnell Aircraft Company (Project No. 0CH-0017)

Introduction

This is our final report on the audit of Subcontract Prices on Firm-Fixed-Price Contracts Awarded to McDonnell Aircraft Company (MCAIR). The Contract Management Directorate made the audit from October 1989 through June 1990. The objective of the audit was to compare proposed and negotiated subcontract prices and determine reasons for significant variances. We also evaluated applicable internal control procedures. For a 6-month period ending December 1989, MCAIR issued 517 subcontracts valued at \$679 million.

Discussion

We found no significant problems with the prices that MCAIR negotiated with DoD for subcontract costs and the prices that MCAIR subsequently negotiated with its vendors. MCAIR often negotiated prices on its subcontracts prior to definitizing unpriced prime contracts with DoD contracting activities.

Of the six subcontracts that met the audit criteria, five contained variances between what DoD negotiated with MCAIR and what MCAIR subsequently negotiated with its subcontractors. On three of the five subcontracts, MCAIR negotiated higher prices with the subcontractor than it negotiated with the Government. On two of the five subcontracts, MCAIR realized additional profit of 1.3 percent (\$27,235 of \$2.0 million) by pricing subcontracts downward after negotiations on the prime contract concluded.

Scope of Audit

We randomly sampled 182 MCAIR subcontract actions issued during the 6-month period ending December 1989 with a value of \$549 million. During this period, MCAIR issued 517 subcontracts valued at \$679 million.

We did not evaluate proposed and negotiated subcontract prices on 176 of the 182 subcontracts sampled for the following reasons:

Prime or Subcontract

Special access programs	72
Not definitized	59
Competitively awarded	14
Non-DoD requirements	8
Not fixed price	2

Subcontract

Price was established prior to negotiation of the prime contract	14
Not related to a specific prime contract	6
Not separately identified in the proposal	<u>1</u>
Total	<u><u>176</u></u>

We did not determine whether proper justification existed for the use of unpriced contracts. Properly used, unpriced contracts can support urgent operational requirements. However, because unpriced contracts are awarded without firm and final prices, they do not provide incentives to achieve cost controls since the contractor has minimum cost risk and operates in a cost-plus mode until negotiations. We are currently performing a separate audit of Undefined Contractual Actions (Project No. OCA-0051) that will determine whether DoD activities are properly using unpriced contracts. We will visit several of the DoD contracting activities that issued unpriced contracts to MCAIR during that audit.

We also reviewed purchase orders, subcontract negotiation memorandums, field pricing reports, cost analyses, prime contracts, prime contract proposals, correspondence, and other documentation related to the sample subcontract actions. We evaluated MCAIR's procedures for obtaining and analyzing subcontract cost or pricing data. MCAIR issued its own guidance, which generally followed the Federal Acquisition Regulation (FAR) and Defense Federal Acquisition Regulation Supplement (DFARS). FAR Subpart 15.8, "Price Negotiations," and DFARS 215.8, "Price Negotiations," established the criteria used in the audit for

pricing prime contracts and subcontracts. FAR Subpart 44.101, "Subcontracting Policies and Procedures," defines subcontracts to include purchase orders and modifications to purchase orders. At the cognizant DoD contract administration office and the Defense Contract Audit Agency resident office, we reviewed prenegotiation and postnegotiation memorandums, field pricing reports, and preaward and assist audit reports.

This economy and efficiency audit was made in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD, and accordingly, included such tests of the internal controls as were considered necessary. The activities visited or contacted during the audit are listed in Enclosure 1.

Internal Controls

The audit disclosed no material internal control weaknesses as defined by Public Law 97-255, Office of Management and Budget Circular A-123, and DoD Directive 5010.38. A minor internal control weakness over continuous surveillance was disclosed and discussed with appropriate DoD contract administration office officials. The officials agreed to take corrective action. This report identifies no potential monetary benefits.

Background

The audit examined subcontracts issued by MCAIR, a major division of the McDonnell Douglas Corporation, located in St. Louis, Missouri. During FY 1988, the McDonnell Douglas Corporation was the largest DoD prime contractor. MCAIR produces the F-15, the F-18, and the AV-8B aircraft.

The FAR and DFARS include procedures to ensure that subcontract costs, negotiated as part of the prime contract price, are fair and reasonable. Prime contractors are responsible for obtaining cost or pricing data from prospective subcontractors, for conducting appropriate cost analyses of subcontractor proposals, and for providing the results of these cost analyses to the Government as part of their own submission of cost or pricing data. On firm-fixed-price contracts, prime contractors can realize additional profit by negotiating subcontractor prices downward subsequent to negotiations with the Government.

Prior Audit Coverage

Office of the Inspector General, DoD, Report No. 90-057, "Evaluation of Subcontract Price Proposals," issued April 9, 1990, determined that contractors did not provide the Government with results of their cost analyses for subcontracts that were negotiated subsequent to reaching agreement on prime contract prices. Procurement officials also did not protect DoD's interest when subcontract negotiations were not completed

until after prime contract negotiations. The audit estimated that DoD contracts were overpriced by \$94 million because procurement officials did not take sufficient actions to ensure that subcontract cost or pricing data were complete and timely. The report recommended that the Assistant Secretary of Defense (Production and Logistics) issue a policy memorandum to the Military Departments and Defense Agencies emphasizing to procurement officials the need to require prime contractors to comply with the FAR. It also recommended actions to protect the Government's interests when substantial subcontract costs have not been negotiated before agreement on price. The Assistant Secretary has agreed to implement the recommendations.

The General Accounting Office (GAO) issued Report No. GAO/NSIAD-89-68, "Contract Pricing - Contractors Should Provide Historical Vendor Prices to DoD." This report determined that contractors were not providing accurate and reliable material estimates and that DoD procurement regulations did not clearly and specifically require contractors to develop, maintain, and provide historical vendor pricing information. GAO recommended that the Secretary of Defense direct DoD personnel to revise DoD procurement regulations to require contractors to develop, maintain, and furnish historical vendor pricing data in support of proposed prices.

In March 1988, DoD revised DFARS Subpart 215.811, "Estimating Systems," to require that contractors establish and maintain adequate estimating systems, provide guidelines for and characteristics of adequate estimating systems, and provide procedures for conducting estimating systems reviews by the Government. The regulation also requires that administrative contracting officers evaluate whether a contractor's estimating system incorporates the use of historical experience. This DFARS change satisfies the GAO report recommendations.

Report Staffing

A draft of this report was provided to the Assistant Secretary of Defense (Production and Logistics); the Assistant Secretaries of the Army, Navy and Air Force; the Director, Defense Contract Audit Agency; and the Director, Defense Logistics Agency on September 10, 1990. Because there were no recommendations, no comments were required of management and none were received. Since there are no unresolved issues, written comments to this report are not required.

We appreciate the courtesies and cooperation extended to the audit staff. The list of audit team members is at Enclosure 2. If you have any questions on this audit, please contact Mr. Garold E. Stephenson, Program Director, at (703) 614-6275 (AUTOVON 224-6275), or Ms. Victoria C. Hara, Project Manager, at (703) 614-3462 (AUTOVON 224-3462). Copies of the final report will be distributed to the activities listed in Enclosure 3.



Edward R. Jones
Deputy Assistant Inspector General
for Auditing

cc:
Secretary of the Navy
Secretary of the Air Force

ACTIVITIES VISITED OR CONTACTED

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Deputy Assistant Secretary (Procurement), Arlington, VA
Department of Defense Inspector General, Defense Criminal Investigative Service, Arlington, VA
Department of Defense Inspector General, Audit Policy and Oversight, Arlington, VA

Department of the Army

Office of the Secretary of the Army, Director, United States Army Contracting Support Agency, Policy and Procedures Division, Arlington, VA
Headquarters, Army Audit Agency, Alexandria, VA

Department of the Navy

Naval Air Systems Command, Arlington, VA
Naval Plant Representative Office, McDonnell Douglas Corporation, St. Louis, MO
Headquarters, Navy Audit Service, Falls Church, VA

Department of the Air Force

Office of the Assistant Secretary of the Air Force (Acquisition), Pricing Policy Division, Directorate of Contract Manufacturing Policy, Arlington, VA
Headquarters, Air Force Systems Command, Andrews Air Force Base, MD
Aeronautical Systems Division, Wright-Patterson Air Force Base, OH
Air Force Logistics Command, Wright-Patterson Air Force Base, OH
Warner Robins Air Logistics Center, Warner Robins, GA
Headquarters, Air Force Audit Agency, Norton Air Force Base, CA

Defense Agencies

Headquarters, Defense Contract Audit Agency, Policy and Liaison, Alexandria, VA
Central Region, Defense Contract Audit Agency, Irving, Texas
Resident Office, Defense Contract Audit Agency, McDonnell Aircraft Company, St. Louis, MO

Contractor

McDonnell Aircraft Company, St. Louis, MO

Other

General Accounting Office, Washington, DC

MAJOR CONTRIBUTORS TO THE AUDIT REPORT

David K. Steensma, Director for Contract Management Directorate
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FINAL REPORT DISTRIBUTION

Office of the Secretary of Defense

Assistant Secretary of Defense (Production and Logistics)
Deputy Assistant Secretary of Defense (Procurement)

Department of the Army

Assistant Secretary of the Army (Financial Management)

Department of the Navy

Secretary of the Navy
Assistant Secretary of the Navy (Financial Management)

Department of the Air Force

Secretary of the Air Force
Assistant Secretary of the Air Force (Financial Management and
Comptroller)

Defense Activities

Director, Defense Logistics Agency
Director, Defense Contract Audit Agency

Non-DoD Activities

Office of Management and Budget
U.S. General Accounting Office,
NSIAD Technical Information Center

Congressional Committees:

Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
Senate Ranking Minority Member, Committee on Armed Services
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Ranking Minority Member, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Operations
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